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23 November 2023, Sopron

FENNTARTHATÓSÁGI ÁTMENET: KIHÍVÁSOK ÉS INNOVATÍV MEGOLDÁSOK

SUSTAINABILITY TRANSITIONS: CHALLENGES AND INNOVATIVE SOLUTIONS

Szerkesztők / Editors:

OBÁDOVICS Csilla, RESPERGER Richárd, SZÉLES Zsuzsanna, TÓTH Balázs István

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How to Make European Integration Fair and Sustainable?[1]

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Abstract:
The European project was borne out of the strong desire of Western European politicians to root out wars and create peace and prosperity in Europe in the post-war period. With the Eastern enlargement of the EU, this mission seemed completed. However, a series of crises starting in 2008 with the Global Financial Crisis revealed many pressing problems in the European integration process. The EU needs to adapt to the new geopolitical and geoeconomic realities while it should take new initiatives to make European integration fair and sustainable. In this paper, using a new conceptual framework, we analyse the factors that hinder fairness and sustainability in the EU and suggest broad directions for reforms that can promote the European integration process.

Keywords: European Union, European integration, development, fairness, sustainability
JEL Codes: F15, Q01, E02

1. The nature of the European Integration process

The European project was borne out of the strong desire of Western European politicians to root out wars and create peace and prosperity in Europe in the post-war period (Schuman, 1950). From the beginning, European integration has been fundamentally a political process, albeit it started and progressed the most in the economic area. The main steps to promote economic integration in Europe were the introduction of the European Single Market in 1992, the euro in 1999, and the Banking Union following the 2008-2013 double crisis in Europe.

While these reforms helped propel economic growth and resilience and the global competitiveness of the EU economy, reforms in this area remained incomplete: the single market for services, particularly the digital single market, is far away, several member states are outside the euro area, the European Deposit Insurance Scheme is incomplete, and the Capital Market Union is in its infancy.

Moreover, primarily because of the slow progress in these areas of integration, the EU economy has gradually lost its technological cutting edge in several innovation-driven and knowledge-intensive sectors that generate fast productivity growth globally. Managing the scaling-up phase is difficult for new, innovative firms in high-value-added service sectors because of the lack of a single market for (digital) services and underdeveloped markets for growth capital (Brousseau & Dalle, 2023).

Mainly because of slow and uneven convergence in institutional quality, the economic convergence of Central-Eastern and Eastern European member states has been uneven among and within these countries and marred by slow and uneven social convergence. Moreover, Southern European member states did not converge or started to diverge economically (Landesmann & Székely, 2021). Economic and social fairness has remained a national value held to varying degrees in EU member states with no sign of convergence.

Like the rest of the world, the EU is facing new challenges, most importantly, the need to

[1] The views expressed are solely those of the author and do not necessarily represent the official views of the European Commission.

accelerate the green transition and maintain growth and prosperity in a newly emerging geopolitical and geoeconomic environment (Ratto & Székely, 2023). In designing future reforms, it is also essential to recall that the EU is a heterogeneous union. Member states are in different economic, social, and institutional development phases. Thus, reforms impact their (economic and social) development differently, reflecting differences in institutional quality and capacity. With future enlargement, the heterogeneity in the EU will increase significantly.

The (political) sustainability of the integration process will require sufficient political support for the European project and for pro-European mainstream parties in all member states and among all social groups. Therefore, future reforms should remove the bottlenecks for further economic integration, provide the necessary support for economic development, and ensure that the economic benefits of European integration are fairly distributed among and within member states. Moreover, reforms should help member states to turn economic development into social development and to make the latter evenly distributed.

1.1. Conceptual framework – development as a multidimensional process

To arrive at a solid diagnosis of the origins of the problems of European integration discussed above and to be able to contour those reforms that can help make the process fair and sustainable, we need a suitable conceptual framework. Székely (2024a) offers a framework which views development as a multidimensional process. As the interactions of the dimensions – economic, social, institutional, and environmental – are not separable in our analysis, we should consider all of them even when the focus is on economic development.

The importance of the social dimension of development and its interactions with the economic dimension has gained increasing attention. Similarly, the central role of institutions in the development process has also earned recognition (Acemoglu et al., 2005*)*. By fully integrating these dimensions and the environmental one, our framework takes these ideas one step further. The usefulness of this framework becomes even more apparent when the focus is broader and includes the social and environmental dimensions of development. Considering the new challenges that the EU faces, such an extension is undoubtedly necessary. Green transition is now a top priority of the EU (and globally) because the previous development path was environmentally unsustainable. A significant policy challenge at this stage is to make the necessary green transition economically and socially fair and sustainable.

The EU shapes the development of its member states along all four dimensions. However, the responsibilities of the European, national, and subnational levels of government are distributed very differently across these dimensions and, within dimensions, across the areas of relevance to our study (European Union, 2016.).

1.2. The super dimensions of development: Fairness and Sustainability

An extension of our conceptual framework to include several dimensions of development also requires a broader definition of fairness and sustainability. Thus, we will define these concepts as super dimensions that apply to all dimensions in the framework.

Fairness concerns the extent and nature of inequality in each dimension. *Economic inequality* at the national (Atkinson & Morelli, 2011, 2014; Piketty, 2017), European (Székely, 2024b), and global (Milanovic, 2005) levels has gained increasing attention in the past decades. The distribution of wages, capital earnings, disposable family income, wealth, and consumption are at the centre of domestic policy discussions, and national policies reflect the preferences of the respective societies.

Market income inequality among and within countries is driven by investment, capital allocation, and locational decisions of financial and non-financial firms and by the supply of and demand for skills. The main achievements of economic integration mentioned earlier, particularly the single market, shape these decisions, unleashing powerful agglomeration forces. Countries and regions with good quality institutions are well prepared for the ensuing process and thus greatly benefit. However, countries and regions with weak institutions tend to suffer. Such market outcomes are also strongly influenced by public policies and institutions. The locational choices of firms heavily depend on the quality of institutions in a country or region. Moreover, the availability of people with the proper skill structure also depends on labour market institutions, public policies and government effectiveness in health and education.

Education plays a central role in promoting fair market outcomes (fair distribution of wages), thus limiting the pressure on budgets to redistribute income. In most modern societies, a large part of the education system is public, particularly at the elementary and secondary levels. Highly uneven educational outcomes are the most damaging form of social unfairness and a significant source of economic unfairness (Blanden et al., 2022). Failures of (mostly) public education systems, such as a high share of early school leavers, tend to have particularly significant and long-lasting negative impacts on the fairness of market outcomes (Brunello & Paola, 2014).

Moreover, market outcomes are, in turn, modified by public policies. Social programs redistribute income and deliver health and educational services. Hence, markets and public policies jointly shape the outcome we observe.

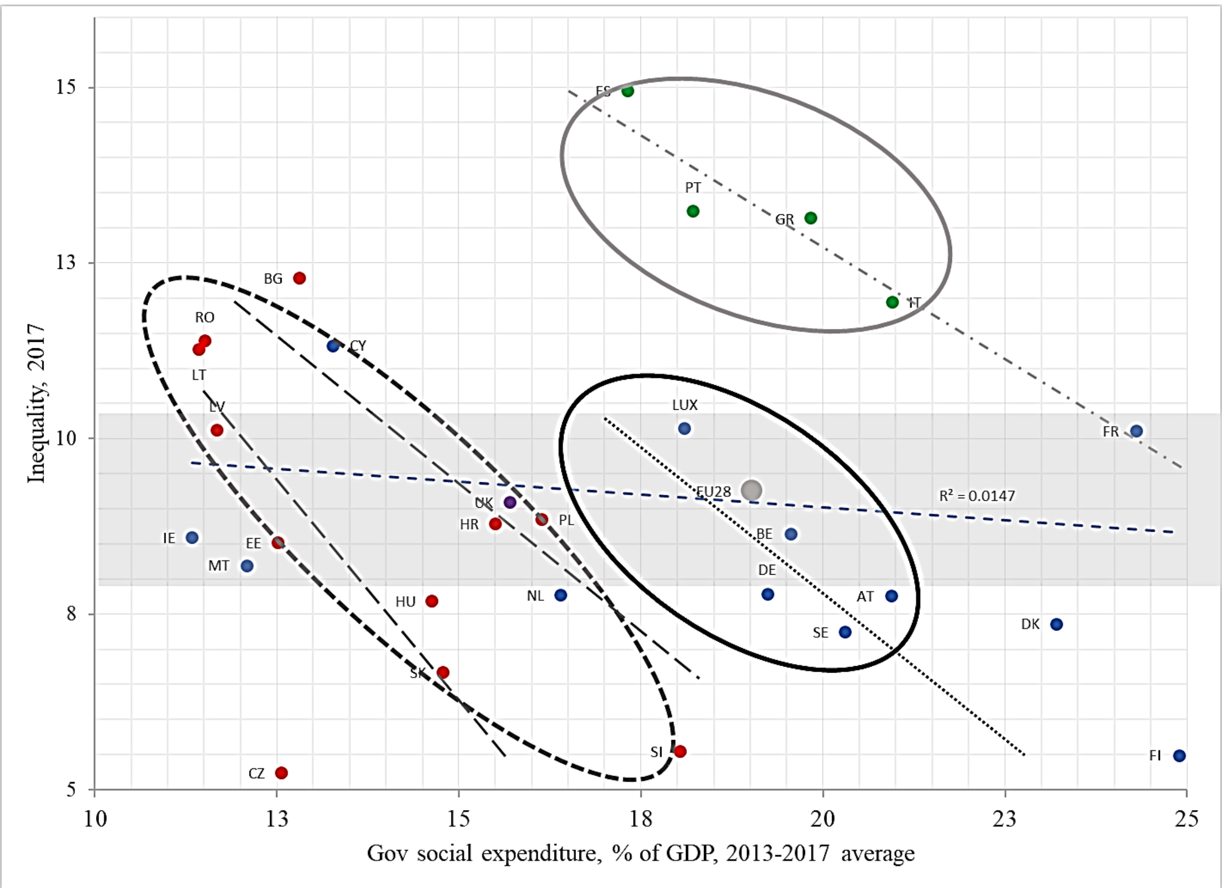
The outcomes of social policies in the EU offer an example to demonstrate the extent to which the result of the same or similar efforts and expenditures may vary across countries. As Figure 1 shows, the share of social expenditures in GDP varies greatly among EU member states, reflecting the differences in preferences of European societies in this regard. However, the size of social spending (relative to GDP) does not seem to determine the degree of social inequality among EU countries.[2] The regression line is flat, and the fit is poor.

However, if we dig deeper and investigate this relationship for different groups of countries, we can detect the expected relationship: more spending leads to less inequality. It is the fundamental justification for publicly financed social programs. However, the curves determining the outcome of different spending levels in these groups are far apart. That is, the same level of spending (and taxation to support this spending) leads to different degrees of inequalities across these groups. Therefore, if governments or societies formulate their policy goals in terms of outcome (the desired degree of equality), the level of public spending to achieve their goals will differ, depending on which group they belong.[3]

Low-quality public finances and inefficient central and local governments—weak public health and education systems and poorly designed social support schemes—create a problematic trade-off between (un)fairness to the most vulnerable social groups and (un)fairness to the taxpayers. Inefficient use of taxpayer money weakens the willingness to fund public expenditure programs, creating fertile ground for populist parties. Generally, when the government fails to deliver in areas people care about, populists tend to gain influence even in societies with strong preferences for the goals of failed public policies (Guriev & Papaioannou, 2022). In short, effective and efficient public policies are a prerequisite for achieving a degree of fairness that makes a development path sustainable.

[2] See the Notes in Figure 1 for a description of the indicator used to measure social inequality. This indicator reflects inequality in income, educational achievement, and life expectancy.

[3] Schuknecht (2023) provides a detailed analysis of the efficiency and quality of public finances of EU countries, including a comparison with Asian countries.



Notes: Social inequality is measured by the UNDP indicator derived from the inequality-adjusted SDI calculations, which reflects inequality in income, educational achievement and life expectancy.

Figure 1: Social Expenditure and Social Inequality in the EU, 2017

Sources: Buti and Székely (2021) Figure 14. Authors' calculations based on Eurostat data. Eurostat for social expenditure, UNDP for social inequality.

1.3. The channels of interactions – how does the EU shape the development of its member states?

The conceptual framework we use describes the development of an economy as a result of its interactions with other economies through different channels, such as trade, investment, finance, migration, knowledge, and institutional interactions. It captures the impact of the EU on the development of its member states through the impact of the EU on the working of these channels. The significant steps of deepening economic integration mentioned earlier, such as the creation of the European single market and the Banking Union and the introduction of the euro, strongly influenced the working of the trade, investment, finance, and migration channels.

1.4. Institutions are for the people in the first place

As institutions will play a central role in our arguments, it is essential to emphasise a few aspects related to them. The original argument for the need for institutions (North, 1990) is related to transaction costs, particularly concerning the cost of enforcing rules/contracts. In our framework, this concerns the economic dimension of development. However, we view the development process as multidimensional and attach particular importance to the social and institutional dimensions of development. The latter dimensions entail formal and informal institutions/rules for human societies beyond those that serve the economy. In our framework, institutions are there to serve people and improve their lives (Sen, 1999; Anand & Sen., 2003; Deaton, 2008). From this vantage point, the social and institutional dimensions of development are as important as the economic one.

Moreover, sustainability in our framework is a super dimension that also applies to the institutional dimension of development. The sustainability of institutions is an essential and oft-neglected aspect of development, particularly concerning EU member states in regions where it is challenging to make development fair and sustainable. A weak institutional channel in the EU implies the slow improvement of institutions in some member states and frequent and wide-spread reform reversals (Székely & Ward-Warmedinger, 2018).

1.5. Heterogeneity in the EU: Member states at different levels of development

Heterogeneity in the economic dimension means that the EU member states are in different phases of economic development. At the core of the EU, the Western and Northern European member states are among the most developed countries in the world. Their economies are knowledge-based and innovation-driven, producing high per capita GDP and income. For them, the essential motivation to form or later join the EU was to use the EU as a supporting factor to keep pace with the other countries in this group. Given the nature of economic development in this group, the central issue is whether the EU provides these economies with sufficient support to maintain their technological cutting edge as this group rapidly moves towards new sectors and technologies. That is, to ensure their companies are concentrated and competitive in the right sectors with high value-added production and strong pricing power. Pricing power is essential to keep primary income high, as it provides the necessary tax base to finance the European welfare state.

The key elements of European integration that are central to the development of this group are the creation of the European single market for services, particularly the digital single market, the capital market union, particularly the creation of a European growth capital market that is a match for those of the US and Asia, and the European policies that can support innovation in critical segments and can help make European universities globally competitive. However, these are the areas where the progress has been disappointing in the EU.

The most developed Central-Eastern, Eastern, and Southern European member states are approaching the stage of development where countries start the transition towards a knowledge-based and innovation-driven economy. It is a difficult stage of economic development where many countries get stalled.[4]

While the EU offers the same opportunities to all member states, only a few use them well to propel themselves to this stage of development. Improving institutional quality becomes a critical factor at this stage of development because innovative firms and economic activities tend to concentrate in countries and regions with high-quality institutions and effective (national and subnational) governments (Buti & Székely, 2021). However, the EU did not make the institutional channel work well within the Union (Besley et al., 2023; Székely & Kuenzel, 2021).[5] Hence, the overall speed of improving institutional quality was slow and varied greatly among EU11 member states. As a result, while the overall speed of convergence to the frontier of economic development for EU11 countries was high, it could have been faster and convergence

[4] Many refer to this phenomenon as the middle-income trap, albeit these countries have high income levels by international classification.

[5] Besley et al. (2023) analyse the nature of states worldwide and form three distinctive groups. The fact that they split EU member states between special interest states and common interest states reflects the fact that the EU could not promote sufficiently institutional development in many member states, sometimes even after four decades of membership.

within this group could have been stronger.

In Southern Europe, institutional quality deteriorated relative to the member states with the highest quality of institutions and relative to several countries in Asia, leading to the divergence of this region from the frontier of economic development. Divergence along any of the dimensions of development is a trend that endangers the fairness and sustainability of the European integration process.

1.6. Crises and fairness

The growth process inherently entails a variety of shocks to the economy. Innovation, the ultimate driver of growth, is by its very nature a process of shock, some of which are large. Disruptive innovations or new general-purpose technologies pose considerable shocks to the economy and society.

Crises are periods when the shocks are too large for an economy, more broadly, a society, to preserve economic, social, and, in many cases, political sustainability. An important underlying factor is a decline of trust in government, which can be lasting for younger generations (Aksoy et al., 2023). In many cases, the development of a country that experiences a crisis has already shown signs of emerging problems with maintaining sustainability on these fronts, typically because it could not achieve the degree of economic and social fairness necessary to do so.

During crises, the degree of economic and social unfairness tends to escalate (Atkinson & Morelli, 2011; Abay et al., 2020; Haciõglu Hoke et al., 2020.). However, crises are also the periods in which policy and institutional innovation can excel and create new ways to restore, or even strengthen, fairness and sustainability of economic and social development. It is valid for national states and their unions, thus for the European Union (Buti & Székely, 2021).

2. Fairness, sustainability, and European integration

As we argued above, the EU shapes the development of its member states in all four dimensions, also because it significantly influences the working of the channels of interaction. While the latter is, by design, the same for all member states, their capacity to adapt to the changes varies, also because European integration changes the working of the channels differently. Hence, the aggregate economic benefits of EU membership for member states and the distribution of these benefits differ among member states.

Weak national institutions tend to limit the economic benefits of European integration and make economic development less fair in a member state. Moreover, they limit the capacity of the countries to convert economic development into fair social development. Hence, if the institutional channel is weak in the EU—when the EU cannot promote a sufficiently fast and even improvement of national institutions— European integration may hinder the sustainability and fairness of economic and social development in some member states. Ironically, the more integration progresses, the more. Failure to maintain fairness also creates a fertile ground for populists and thus weakens public support for the European project (Guriev & Papaioannou, 2022).

European integration and crises

Following a relatively long period free of crises, the EU has been hit with a series of crises starting in 2008 with the Global Financial Crisis, which turned into the European Sovereign Debt Crisis. The EU weathered this double crisis less than optimally (Baldwin & Giavazzi, 2016). An unfinished agenda of European integration left the financial sector unfit for allocating capital efficiently and highly vulnerable to a funding shock. At the same time, the introduction of the European single market (free movement of capital) and the euro increased capital mobility. Slow progress on the structural reform front narrowed investment opportunities and thus produced a savings glut.

When the crisis hit, the necessary institutional and policy innovations were slow, and on many fronts, they produced reforms and policies that turned out to be problematic. As a result, the crisis lasted much longer than in the US, and the subsequent recovery led to divergent growth paths within the EU. These trends were not conducive to fair and sustainable economic and social development in the EU. On the contrary, they made previous negative trends in this regard more pronounced.

The lessons of the European double crisis had been learned, and when the COVID-19 crisis hit Europe, the institutional and policy reforms under the umbrella of the NextGenEU were decisive and much better designed. SURE was up and running in a few months, and the RRF was implemented at an unprecedented speed. The "cash for reforms" approach of the RRF combined strong pecuniary incentives for well-identified growth-enhancing reforms stemming from the European semester with a focus on spending in strategically important areas, such as green and digital transformation.

Following the outbreak of the war on Ukraine and the decoupling from Russia, spending priorities have been quickly adapted to the new situation (RePowerEU). The focus was kept on a quick reorientation of the energy imports. Overall, the EU is weathering the current crisis much better than the previous one, making the EU a helpful institution for its member states to mitigate the inevitably harmful impacts of a crisis.

3. How can we make the European project fair and sustainable?

Our analysis points to a three-pronged strategy to make progress towards a fair and sustainable European project. This strategy could help produce improvements that are appropriately distributed among member states in different phases of development and among different social groups within member states.

3.1. Restoring the cutting technological edge of the EU

With a weak knowledge channel and slow scaling up of innovative new firms in the EU because of the lack of a digital single market and growth capital, the position of the EU in innovation and research has been eroded. As we argued above, completing the single market for services, particularly the digital single market and the Capital Market Unions, is essential for accelerating research and innovation and, through this, strengthening the competitiveness of EU companies in the most dynamic industries in the world economy.

The EU is particularly trailing global leaders in sectors where new disruptive technologies (such as AI) drive development. Therefore, reforms that promote the availability of growth capital, focusing on the scaling-up phase, will be essential. The extent to which the EU is trailing the global leaders in this segment of financial services is alarming (Brousseau & Dalle, 2023).

It has been long recognised that accelerating innovation will be crucial for the success of the green transition (Aghion et al., 2009). For a long, the narrative has been that the EU is a leader in green technology. Thus, by promoting green transition, EU policies can bring about new opportunities for the EU to restore its technological cutting edge. However, for the same reason as mentioned above, the leading position of the EU in green technology has been eroded, too. China is the leader in solar energy and a significant player in developing and producing batteries, including research and innovation, and is rapidly catching up with the US in producing and developing electric vehicles.

Universities (higher education) are central to a well-working knowledge channel. Brexit not only took away the most significant global growth capital centre from the EU but also resulted in the loss of globally competitive research universities. Beyond research, globally competitive universities are crucial to ensure the required skill structure, including attracting global talent to the EU. Therefore, reforms that can enhance the global competitiveness of EU universities are crucial to restoring the EU's technological cutting edge.

Creating a segment of European Research Universities that compete on an equal footing in the EU would allow the EU to start catching up with the US and the UK and fend off the increasingly fierce competition from China. Designing a system that offers equal opportunity for students from all EU countries and can attract the best global talent is also essential. Given the focus on research and innovation and global talent attraction, the post-gradual segment is of paramount importance.

Restoring the technological cutting edge of the EU and boosting the global competitiveness of EU firms based on faster productivity growth is also essential to maintain the economic foundations of the European welfare system. A technological leadership position is essential to maintain the pricing power of EU producers, without which it is difficult, if not impossible, to compete with emerging economies with smaller but increasingly capable and efficient governments (Schuknecht, 2023).

3.2. Strengthening institutions and evening out differences in institutional quality

Our analysis points to the central role of institutions regarding the way European integration shapes the fairness and sustainability of development in the EU member states. As we argued above, member states are heterogeneous in many respects, including the overall quality of institutions and the unevenness of institutional quality across different types of institutions and regions within a member state. Consequently, the impact of European integration on a member state will be very different, depending on the stage of development and the evolution of institutions in the member state concerned (Székely, 2023).

If we accept this diagnosis for all member states, the broad direction for policies that could help make the European project fair(er) and (more) sustainable seems straightforward. The focus should be on European, national, and subnational reforms that promote better institutions and reduce the unevenness in institutional quality. In short, the focus should be on the institutional dimension of development and improving the working of the institutional channel within the EU.

We argued above that the focus should be on the lives people live. Hence, the necessary reforms should concern not only those institutions that are important for the economic dimension of development but also those that matter for the social and environmental dimensions. While the economic dimension has long been at the centre of reform efforts, based on our analysis, the importance of the social and environmental dimensions for the (political) sustainability of the European project will increase.

For the most developed countries in the EU, the most significant reforms are those that help restore the technological cutting edge of EU firms and economies. Success on this front will lead to the creation of many new innovative firms and the rapid scaling up of such firms. Firms and economic activities in innovation-driven and knowledge-based sectors are heavily concentrated geographically, even within highly developed countries and in countries and regions with the best institutions. Thus, a success on this front will unleash powerful agglomeration forces. To adjust to this process, reforms that reduce unevenness in institutional quality among and within countries will be essential.

The experience of the Eastern enlargement of the EU provides further support to call for such reforms. A combination of well-working trade and investment channels and a powerful finance channel on the one hand, and a weak institutional channel on the other made the impact of EU membership on fairness and sustainability mixed, if not harmful, in some of the Central and East European and Southern European member states (Andor, 2019; Székely & Kuenzel, 2021).

The key for the most developed countries in these regions is to progress with the transition to a knowledge-based and innovation-driven economy (and society). For this to happen, these countries should radically improve institutional quality, increase government efficiency, root out corruption, and even out institutional quality internally as quickly as possible.

3.3. Increasing government efficiency and improving the quality of public finances

We also argued that the effectiveness and efficiency of government vary across policy areas and among and within countries. Moreover, heterogeneity also characterises European institutions in this regard. Hence, reforming institutions should go hand-in-hand with reforms that strengthen the effectiveness and efficiency of the agents that enforce rules and implement policy interventions at all levels of government.

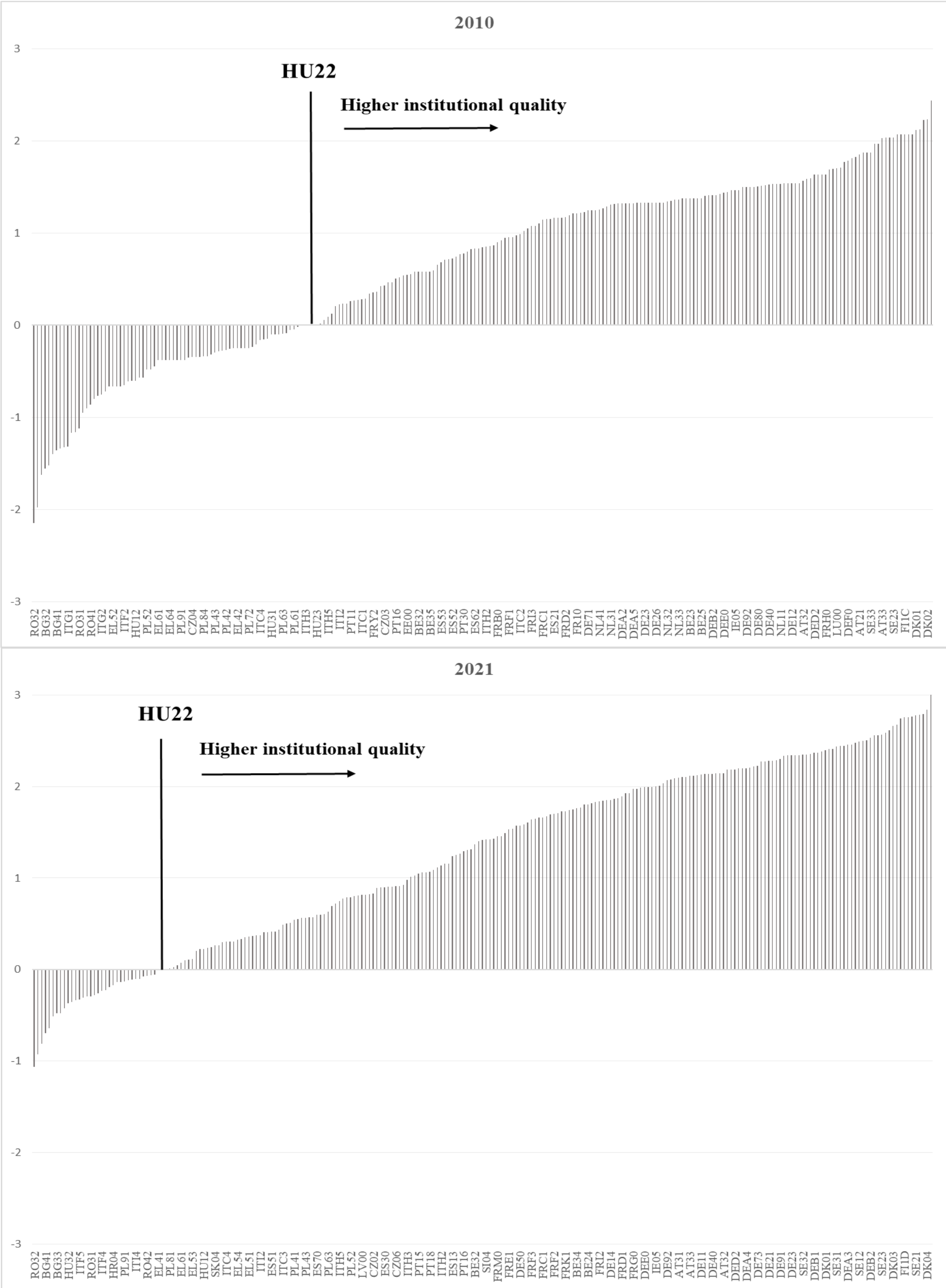
The need to improve government efficiency and the quality of public finances also concerns European institutions and spending programs. As the EU budget is significantly smaller than the national budgets, improving the quality of public spending is even more imperative.
A fairer European integration process, entailing better quality European institutions and spending programs, would be economically and socially more sustainable. Moreover, it would strengthen and widen the public support for the European project. An EU that improves people's lives would help close the political representation gap in this regard, as it would bring the median voter's preferences for European integration closer to their representatives (Günther, 2023).

3.4. What local governments can do to benefit more and more evenly from European integration

Presenting in Sopron a paper which emphasises the importance of local governments naturally invites the author to reflect on the reforms and policies a city with such a rich history and traditions could introduce to maintain fair and sustainable development. The key message remains valid. In the past decade, the region[6] broadly maintained its relative position within Hungary regarding institutional quality. However, as Figure 2 shows, there is a lot to do to keep up with regions in other countries in the EU, including those in the neighbourhood who directly compete with Sopron.

For all (NUTS2) regions in Hungary, the distance from the regions with the best quality institutions in the EU increased between 2021 and 2010. It is similar to the trend in Southern European countries following the turn of the century. If slow convergence to the frontier in this regard limits economic convergence and weakens the capacity of countries to convert economic convergence into social convergence, a divergence in institutional quality creates the risk of halting or reversing economic and social convergence. Such development would also pose a challenge to the political sustainability of the European project.

[6] The HU22 (NUTS2) region of Western Transdanubia, which includes the county of Győr-Moson-Sopron.



Notes: The figure shows the difference between the EQG index values of the NUTS2 region concerned and region HU22 (Western Transdanubia) in Hungary. Regions to the right are regions with higher overall institutional quality.

Figure 2: European Quality of Government Index for EU NUTS2 regions in 2010 and 2021

Sources: European Quality of Government Index, University of Gothenburg, The Quality of Government (QoG) Institute. The dataset was downloaded on 14 January 2024. For 2021, see Charron (2022), for 2010, Charron (2014).

While the overall evolution of institutions in a country significantly determines the paths for its regions, the evolution of European regions in this regard suggests that a region can outperform its national trend (Charron, 2022). The legacy of the legendary mayor of Sopron, Mihály Sopronyi-Thurner, offers rich lessons in this regard. Upon his initiative, the predecessor of the University of Sopron moved to the town following the break-up of the Austro-Hungarian Monarchy. The father of the euro, Alexandre (Sándor) Lámfalussy, was educated in Sopron, leaving the town well-equipped for his university studies at Leuven and Oxford.[7] A long tradition of educational excellence should help Sopron place its secondary schools among the best ones in the country again.

Declaration of interest

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The data supporting this study's findings are available on request from the author.

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[7] He attended the Saint Astrik Gymnasium run by the Benedictines (bencés Szent Asztrik Gimnázium) (Durgula & Fábián, 2016).

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